Pass-through entity withholding

Update: December 1, 2005

The 2005 North Dakota Legislature enacted legislation requiring a pass-through entity to withhold income tax at the rate of 5.54 percent from the year-end distributive share of income of its individual owners or beneficiaries who are nonresidents of North Dakota. For this purpose, a pass-through entity means a partnership, S corporation, trust, or limited liability company treated like a partnership. A pass-through entity does not include a publicly traded partnership as defined under Internal Revenue Code § 7704(b). The year-end distributive share of income means the amount of income reportable to North Dakota as shown in Schedule A of North Dakota Form 58 (partnership and LLC), Schedule A of North Dakota Form 60 (S corporation), or Schedule 3 of North Dakota Form 38 (trust).

A pass-through entity does not have to withhold income tax from the distributive share of North Dakota income of a nonresident individual owner or beneficiary if:

- The distributive share of North Dakota income for the taxable year is less than $1,000;
- The tax commissioner determines that the distributive share of North Dakota income is not subject to withholding; or
- In lieu of filing his or her own North Dakota individual income tax return, the nonresident individual owner or beneficiary elects to be included in a composite individual income tax return filed by the pass-through entity. For this purpose, however, a pass-through entity is not eligible to file a composite return unless there are at least two nonresident individual owners or beneficiaries who elect to be included in it.

[Senate Bill 2045; S.L. 2005, chapter 563; amending N.D.C.C. § 57-38-31.1]

Does this new requirement apply to a pass-through entity's 2005 taxable year?

No. The new income tax withholding requirement does not apply to a pass-through entity's taxable year beginning on or after January 1, 2005, and before January 1, 2006. Although the legislation provides that the new requirement applies to taxable years beginning after December 31, 2004, the tax commissioner determined that the timing of the legislation's enactment and the constitutionally-defined effective date of August 1, 2005, would create a burden for pass-through entities to meet the new requirement with respect to their taxable years beginning in 2005.

When will this new requirement be applied?

The new income tax withholding requirement will apply to a pass-through entity's taxable years beginning on or after January 1, 2006. As a practical matter, this means that the first reporting and payment of withheld income tax will not be required until the end of a pass-through entity's 2006 taxable year.

How will the pass-through entity report and pay the withholding?

The Office of State Tax Commissioner anticipates incorporating the new pass-through entity income tax withholding provisions into the partnership, S corporation, and fiduciary income tax returns as part of a major revision of those forms for the 2006 taxable year. The income tax required to be withheld on the distributive shares of North Dakota income will be calculated on the applicable return, and the payment of the withheld income tax will be submitted with the return when it is filed. The major revision of the partnership, S corporation, and fiduciary income tax returns for 2006 will include the creation of a state pass-through member schedule, analogous to the federal Schedule K-1, that the pass-through entity must provide to each of its owners or beneficiaries. Any income tax withheld by the pass-through entity would be reported to a nonresident individual owner or beneficiary on this schedule.

Can a pass-through entity avoid the withholding requirement altogether by filing a composite individual income tax return on behalf of all of its nonresident individual owners or beneficiaries?

Yes, provided all of the nonresident individual owners or beneficiaries are eligible to be included in the composite return, and all of them elect to be included in it. To be eligible for inclusion in a composite individual income tax return, the nonresident individual owner or beneficiary must not have any other income from North Dakota sources except the distributive share of income from one or more pass-through entities doing business in North Dakota. For more information about composite filing, see the Income Tax Guideline: Composite Filing Method.

When will more details be available on this new withholding requirement?

The Office of State Tax Commissioner is currently involved in a major project to install and implement a new integrated computer tax system. The planned overhaul of the partnership, S corporation, and fiduciary income tax returns to incorporate the new pass-through income tax withholding provisions must be coordinated with the integrated tax system project, and the procedural details for the new withholding requirement are dependent on that process. More complete details on the conditions and procedures applicable to the new pass-through income tax withholding requirement will most likely not be available until the summer of 2006.

Significant developments that you need to know about will be posted to this web site, so check this web site often to stay informed.

The Office of State Tax Commissioner will also provide the complete and final details to pass-through entities and tax professionals by way of special mailings, newsletters, and the instructions to the 2006 partnership, S corporation, and fiduciary income tax returns.